



**EnergyAustralia**

LIGHT THE WAY

20 March 2019

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Dear Mr Feather

### **AER Position Paper – Default Market Offer Price – November 2018**

EnergyAustralia is one of Australia's largest energy companies with around 2.6 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. We also own, operate and contract an energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation in the National Electricity Market (NEM).

EnergyAustralia welcomes the opportunity to make this submission to the Australian Energy Regulator's (AER) draft determination on the default market offer (DMO) price. We recognise that AER's task in developing the DMO is set out in the Australian Government's terms of reference and otherwise in the draft Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019 (Code). We appreciate the AER, like all stakeholders, has also been severely challenged by the government's compressed timeframes and its unusual approach to giving effect to price regulation via the draft Code.

We support the introduction of the DMO as a safety net for customers that cannot meaningfully engage in the market, and in better enabling customers to compare retailers' market offers. The scope and impact of the DMO need to be carefully communicated to customers to ensure its benefits are fully realised and the AER has an important role in this. We encourage the AER to provide more transparency on how any updates to its cost trend analysis and other uncertainties are accommodated in its top-down method. These points are expanded in the attached.

If you would like to discuss this submission, please contact Lawrence Irlam 03 8628 1655 or [Lawrence.irlam@energyaustralia.com.au](mailto:Lawrence.irlam@energyaustralia.com.au).

Regards

**Sarah Ogilvie**  
Industry Regulation Lead

### **We support the DMO and the AER's general approach**

We support the aim of the DMO in providing a safety net for customers on high standing offer prices, while still encouraging consumers to switch to market offers and benefit from retail competition.

We support the AER's top-down pricing methodology and consider it has identified a suitable range of relevant public information for its task given the time available. The AER has appropriately outlined the need to rely on judgement when using this information and its considerations in doing so. Some of these factors (e.g. contained in section 3.4 of the AER's draft determination) are not explicitly outlined in the draft Code and we expect the AER to continue to have regard to them in making its final determination and beyond. Consistency in the AER's objectives and in the factors it considers will provide certainty for retailers and is important for fostering competition.

While a top-down approach has been appropriate in the first year of setting the DMO, this may not be most appropriate method in future years to account for changes in underlying costs. The AER should consult with stakeholders about its approach in subsequent years.

### **The AER should demonstrate how its method accommodates cost changes**

The AER's top-down method poses a challenge in determining the point at which the AER would adjust its maximum DMO price to accommodate material and uncertain cost changes, particularly at the wholesale level.

While we support the AER's top-down approach we recommend it provide further transparency (i.e. attempt to quantify) on how unknown or uncertain variables might affect the DMO, particularly where it sits relative to market offers. Specifically, we interpret the 'margins' above market offers calculated by the AER<sup>1</sup> to be, in its view, sufficient to incentivise customers to switch onto market offers and critical to the policy intent of the DMO. (We reiterate the point made in our prior submission that the AER's method will actually undercut some retailers' market offers.)

The AER also indicated its 'margins' provide a buffer to accommodate the following uncertainties:

- the validity of using offers as at October 2018 when setting its range, including potential downward bias because of the AER's assumption that customers received all conditional discounts
- changes in drivers not captured in the AER's analysis of forecast cost inputs
- unaccounted for variables that may affect the median of observed market offers.<sup>2</sup>

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<sup>1</sup> AER, *Draft Determination – Default Market Offer Price*, February 2019, table 8.

<sup>2</sup> *ibid*, p. 44.

The AER should give some dimension to these uncertainties and testing the impact of alternative approaches where available, for example, in the same way as it has done when considering use of a simple versus weighted average of retailers' standing offers.<sup>3</sup>

As the AER is aware there is a high degree of uncertainty and materiality in wholesale cost fluctuations, as well as known issues in attempting to model these across different retailers. The AER has noted it will update the AEMC's wholesale cost estimation method at the end of March. Wholesale costs for 2019-20 are likely to be materially different from the large reductions outlined in the AER's draft determination. We note that the AER considered total cost reductions of between 3.8 and 8.2%, or just over 5% on average, to be relatively modest in the context of determining the likely direction and magnitude of input cost changes.

We do not support a mechanistic approach of linking underlying cost changes to the DMO, and this does not appear to have been the AER's intent in examining these costs. However, the AER's analysis and comments infer certain expectations on a range of elements in its decision, including uncertainties in its cost forecasting assumptions, 'actual' underlying cost changes and the scale of the 'margin' inherent in the AER's draft DMO. As the AER would be aware, futures prices covering contracts for the DMO determination period have risen by roughly 10 to 20% from those observed by the AEMC in 2018. Overall this may not result in a material difference in expected costs for retailers such that the DMO should be changed from its draft determination values, however such a situation could arise by the time the DMO takes effect. We recommend the AER test its revised cost calculations with stakeholders, particularly updating of the AEMC's method in March, as well as any corresponding need to adjust the DMO.

In assessing costs changes and the suitability of starting point prices, the AER has discounted using offers after October 2018 to avoid the influence of "strategic behaviour in response to the proposed pricing approach".<sup>4</sup> Contrary to such expected behaviour, several retailers reduced standing offer prices on 1 January.<sup>5</sup> There are likely to be a variety of reasons why price offers of all retailers may have changed since October 2018, however the AER may find use in examining the latest available offers to identify any systematic changes that correspond to cost trends.

Generally, the AER needs to clarify how its methodology accounts for cost changes in setting final DMO values. This is important in the event current price levels or its top-down method is carried into future DMO determinations, and in considering possible pass-throughs or reopening of the first DMO determination. We have recommended that the Code include such pass-through provisions and note that the AER may need to develop a materiality threshold for this purpose.

### **The AER's method may not appropriately recognise cost drivers in all regions**

The shallow and volatile nature of the South Australian (SA) energy market means under a DMO it is likely only retailers with a generation position will be able to offer highly competitive offers. For many smaller retailers in the SA market, the DMO may be the only price they can offer. This could result in some retailers choosing to exit the market or to be non-active participants (offer only the DMO and no discounts). The consequence

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<sup>3</sup> *ibid*, p. 40.

<sup>4</sup> AER, p. 38.

<sup>5</sup> AER, p. 27.

of this will be a lessening of competition, increased market concentration and less choice for customers. The AER may wish to explore this further and consider whether this warrants a different approach for setting the DMO for SA relative to other regions.

### **The impact of the DMO needs to be carefully communicated**

We encourage the AER to give further thought to its communications and work with the Australian Government and retailers in managing customer expectations around the impact of the DMO. While the intent of the DMO is clear, there are also a range of implementation issues for retailers that are poorly understood by policy-makers that affect how the AER makes its DMO determinations. Some of these issues are outlined below.

The re-imposition of price regulation is coming at a time where there is a heightened concern around energy prices, a distrust of energy companies and the energy system more generally with a range of market and policy impacts affecting product offerings. In this environment, there is a need to carefully communicate the intended impact and scope of the DMO. We urge the AER to work with the Australian Government in making announcements, particularly about the number of customers that will directly benefit from the DMO and to what extent. This includes consideration of customers (including our own) that have already benefited from price reductions from 1 January 2019, as well as working with retailers to understand their related decisions affecting market prices and discounting from 1 July. Political announcements and media headlines regarding the DMO have quoted total customer numbers on standing offers, and maximum price reductions (i.e. 'up to' certain dollar amounts).<sup>6</sup> As the AER is aware, the scope of the DMO is initially limited to standing offer customers on flat tariffs only. The AER would also be aware that, through the operation of its retailer exemption guideline, the regulation of standing offer prices will affect prices offered to customers in embedded networks.<sup>7</sup>

Price impacts for these customers will depend on a range of factors. The AER's draft report notes DMO amounts are indicative and not a maximum bill. Customers are unlikely to make this distinction. Further communications will be necessary to manage expectations they will be charged certain amounts or receive bill reductions under the AER's/ Government's maximum price as quantified in the media or in media releases. Above all we would be concerned if the DMO was promoted as something that delivers material and universal price reductions and discourages customers from seeking out market offers.

### **Raising expectations of unregulated behavior could be counterproductive**

The AER's draft determination listed its expectations that retailers would take reasonable steps to ensure no customers are worse off under the DMO, including via tariff rebalancing, maintaining discounts and not increasing standing offers that were below the DMO.<sup>8</sup> The ministerial press release accompanying the draft DMO also suggested the ACCC will have some sort of oversight role in ensuring retailers do not increase market

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<sup>6</sup> For example, "millions of customers" promised savings of "up to \$832" per year <https://www.smh.com.au/politics/federal/government-s-default-energy-price-to-save-consumers-up-to-832-a-year-20181022-p50b9s.html>

<sup>7</sup> See condition 7 of Core Exemption Conditions in AER, *(Retail) Exempt Selling Guideline - Version 5*, March 2018.

<sup>8</sup> AER, *Draft Determination – Default Market Offer Price*, February 2019, p. 10.

offers in response to the DMO.<sup>9</sup> However there are no corresponding provisions on retailers or regulators contained in the draft Code provisions.

Given the current environment of retailer distrust, perpetuated for political gain, any shortcomings in implementing the DMO could be blamed on retailers rather than those responsible for designing it. Retailers acting in good faith to ensure the maximum number of customers benefit from the DMO may inadvertently result in some customers being worse off when setting their prices for standing offer tariff components. In fact, the AER's grouping of controlled load tariffs as proposed by the DMO, is likely to result in some customers being worse off even where their consumption patterns haven't changed (discussed further below).

Furthermore, the combined reduction in standing offer prices and requirement to compare market offers against the DMO may result in a loss of perceived benefit (e.g. a lowering percentage or dollar value discounts). As noted above, customers may expect to receive price reductions announced for the average customer (including those communicated by the AER) and may inappropriately attribute any smaller reductions they receive to retailer profiteering.

In any monitoring of changes in market offers in the wake of the DMO and making any further comments on 'strategic behaviour', the AER should also carefully consider statements regarding its use of prices as at October 2018 as a starting point in its methodology as noted above.<sup>10</sup>

### **Re-regulation of controlled load tariffs**

The draft DMO sets a single rate for controlled load customers, which will see some customers worse off. Controlled load tariffs exist to provide a different tariff for different household appliances, for example solar hot water heaters, pool pumps etc. The tariff charged aims to cover the cost of running those assets at a particular time of the day and for a given length of time. They generally work by providing a lower price signal to shorter duration appliances, compared to those that operate for longer.

To comply with the single controlled load DMO, retailers must split their controlled load tariffs or "peak usage rates" across a fixed amount of consumption. As no distinction is made between different types of controlled load, the DMO has the unintended consequence of flattening both controlled loads into a single price which in turn will remove any intended pricing signal. As a result, customers that switch to the DMO may find the tariff for their controlled load is higher.

### **Other implementation issues**

The DMO's impact on the advertising of market offers, including which offers must be compared to the DMO reference bill, is uncertain and will not be resolved until the Code takes effect. We appreciate the AER is also affected by this moving target, including potential changes to what the AER must consider in setting the DMO. We and other retailers are now incurring costs in implementing changes to marketing and pricing based on information now at hand in the draft Code and the AER's draft determination.

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<sup>9</sup> The Hon Josh Frydenberg MP, Treasurer, The Hon Angus Taylor MP, Minister for Energy, *Establishing a price safety net to deliver a better deal*, Joint Media Release, 23 February 2019.

<sup>10</sup> AER, p. 30.

Material changes from here (including the albeit low probability that the Code is disallowed by parliament) would result in a considerable waste of resources.

One striking uncertainty arising between the draft Code and the AER's draft determination is the need to develop a reference bill for time-of-use (TOU) market offers. Our reading of the draft Code is that there is not requirement to advertise TOU market offers in comparison to the DMO. We note that the AER has developed a benchmark TOU consumption profile for such a purpose and, if required under the final Code, should clarify further steps in any comparison calculation in its final determination.

The AER should also be mindful of its administration of rule requirements regarding cost reflective tariffs for distribution network service providers. Generally, the introduction of cost reflective tariffs in the form of TOU and demand-based pricing may not be consistent with the policy narrative that customers should face simple, fair and comparable prices. The introduction of cost reflective tariffs simultaneously with the DMO could create confusion for customers and requires an appropriate communication strategy from governments and the AER.